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Tax Consequences of Assigning Life Insurance - Time for Another Look

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Tax Consequences of Assigning Life Insurance—Time For Another Look

Douglas A. Kahn and Lawrence W. Waggoner***

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I. INTRODUCTION

The Taxpayer Relief Act of 1997 furnishes the courts and the Internal Revenue Service an opportunity to close certain loopholes in the federal tax consequences of assigning life insurance. About twenty years ago, we published an article arguing that the tax consequences of assigning life insurance affords taxpayers unwarranted opportunities for tax avoidance.¹ Since then, developments in the case law and Internal Revenue Service rulings have broadened the loopholes. In this update of our article, we show how the new tax law supports our original position.

The most litigated estate tax issue concerning life insurance² is whether the proceeds are includible in the insured's gross estate. This question is usually governed by section 2042 of the Internal Revenue Code of 1986 (Code), the estate tax provision specifically dealing with life insurance. To be included under section 2042, the insured must "possess at his death any of the incidents of ownership [in the policy], exercisable either alone or in conjunction with any other person," or the proceeds must be "receivable by the [insured's] executor."³

Usually at minimal gift tax cost, an insured can avoid section 2042 by giving the policy to the beneficiary or placing it in an irrevocable trust.⁴

1. Douglas A. Kahn & Lawrence W. Waggoner, *Federal Taxation of the Assignment of Life Insurance*, 1977 Duke L.J. 941.

2. Under the terminology used in connection with life insurance, the *insurer* is the company that issues the policy, the *insured* is the person whose life is insured by the policy, the *beneficiary* is the person to whom the proceeds of the insurance are payable, and the *policyholder* is the owner of the policy. As owner, the policyholder possesses the economic rights in and power over the policy, including the right to surrender the policy for cash, borrow against the policy, and name the beneficiary. The policyholder need not be the insured.

3. IRC § 2042. Some of the previously unresolved questions concerning the interpretation of § 2042 have apparently been settled. Compare *Estate of Skifter v. Commissioner*, 468 F.2d 699 (2d Cir. 1972) (broad fiduciary powers conveyed to, and not retained by, an insured did not constitute an "incident of ownership"), and *Estate of Connelly v. United States*, 551 F.2d 545 (3d Cir. 1977) (power to elect settlement option, and thus to affect proceeds' payment schedule, the exercise of which required consent of employer and insurer, did not constitute an "incident of ownership" under IRC § 2042), with *Terriberry v. United States*, 517 F.2d 286 (5th Cir. 1975) (power, as a trustee, to elect a settlement option constituted an "incident of ownership" even though insured's wife could terminate his power at will), and *Rose v. United States*, 511 F.2d 259 (5th Cir. 1975) (power, as a trustee, to alter time and manner of enjoyment of policy held in trust constituted an "incident of ownership"). *Skifter* is the most significant case in that list. Although the Commissioner initially rejected the *Skifter* decision in Rev. Rul. 76-261, 1976-2 C.B. 276, the Commissioner later revoked that ruling and adopted the *Skifter* position. See Rev. Rul. 84-179, 1984-2 C.B. 195.

4. For gift tax purposes, a life insurance policy is valued on the date of the gift without regard to the insured's actual life expectancy or medical condition. See *infra* text accompanying notes 26-28.

If the insured dies within three years after making the gift, however, and if the policy was not terminated, the full value of the proceeds may be included under another section of the Code, section 2035. As amended by the Taxpayer Relief Act of 1997, section 2035 provides that if the decedent, within three years of death, transferred an interest in or relinquished a power over property, the value of which would otherwise have been included in the decedent's gross estate under certain specified sections including section 2042, then "the value of the gross estate shall include the value of any property (or interest therein) which would have been so included" had the transfer or relinquishment not taken place.⁵

Under the case law that predated the 1997 Act, it was well established that a gift of life insurance within three years of death caused the full value of the proceeds to be included in the insured's gross estate if no post-assignment premiums became due.⁶ If, however, the insured outlived the period covered by the last pre-assignment premium, post-assignment premiums had to be paid in order to keep the policy in force. If the insured paid the post-assignments premiums, the case law predating the 1997 Act included the full value of the proceeds in the insured's gross estate.⁷ If the assignee paid the post-assignment premiums, the pre-1997 Act case law reduced the amount includible.

The leading case on the latter issue is *Estate of Silverman v. Commissioner*,⁸ a case decided by the Tax Court in 1973. The Tax Court struck a ratio of premiums paid by the insured and by the assignee to the

5. IRC § 2035(a), as amended by the Taxpayer Relief Act of 1997, P.L. 105-34 § 1310. Section 2035 does not apply if an insurance policy is transferred pursuant to a bona fide sale for adequate and full consideration in money or money's worth. See IRC § 2035(d).

6. See, e.g., *Berman v. United States*, 487 F.2d 70 (5th Cir. 1973); *Bel v. United States*, 452 F.2d 683 (5th Cir. 1971); Rev. Rul. 71-497 (situation 2), 1971-2 C.B. 329. See also Regs. § 20.2042-1(a)(2).

7. See, e.g., *Estate of Compton v. Commissioner*, 532 F.2d 1086 (6th Cir. 1976); *Vanderlip v. Commissioner*, 155 F.2d 152 (2d Cir. 1946). See also *Estate of Silverman v. Commissioner*, 521 F.2d 574, 576 (2d Cir. 1975). In *Compton*, the premiums on a group-term life insurance policy, which became due after the insured had assigned the policy, were presumably paid by the insured's employer. If so, the insured would be deemed to be the transferor of the premiums. See *Estate of Porter v. Commissioner*, 442 F.2d 915, 919-20 (1st Cir. 1971); Rev. Rul. 76-490, 1976-2 C.B. 300.

8. 61 T.C. 338 (1973), aff'd on the limited grounds raised on appeal, 521 F.2d 574 (2d Cir. 1975). When *Silverman* arose, one of the requirements for including the proceeds of an assigned life insurance policy in the insured's gross estate was that the assignment have been made in contemplation of the insured's death as well as having been made within three years of that death. In *Silverman*, the Tax Court found that the insurance policy, which had been assigned to the insured's son six months prior to the insured's death, had been assigned by the insured in "contemplation of his death." The "contemplation of death" requisite was eliminated when the Code was amended in 1976.

total premiums paid on the policy.⁹ The court, then, applied that ratio to the proceeds of the policy to determine the amount includible in the insured's gross estate. In *Silverman*, the insured had paid 88.71% of the premiums and the assignee had paid 11.29% of the premiums. The Tax Court held, therefore, that 88.71% of the proceeds of the policy were includible in the insured's gross estate and 11.29% were excludible.

Our position is that the *Silverman* analysis gives taxpayers a windfall and provides life insurance an unfair advantage over other investment vehicles. We argue that *Silverman* was inconsistent with the law existing when the case was decided and, more importantly, is inconsistent with section 2035 as reformulated by the 1997 Act. To set the stage for our argument, we begin with brief discussions of the operation of life insurance, the different types of life insurance, and the economic elements that comprise life insurance. We next survey the relevant provisions of the tax laws, as they now exist, that apply to life insurance policies and proceeds. Finally, we examine several different types of circumstances in which an insured has assigned life insurance to a third party and consider whether the current tax treatment of such assignments "has it right," in light of the amendments to section 2035 made by the 1981 Act and especially the 1997 Act. Special emphasis will be given to the *Silverman*-type situation in which the insured assigns a policy within three years of death and the assignee pays the post-assignment premiums.

II. THE ECONOMIC COMPONENTS OF LIFE INSURANCE

Life insurance covers the risk that the insured will die while the policy is in force. Once purchased, a policy remains in force as long as the premiums are paid. Unless a policy is a single-premium policy, premiums become due at specified intervals.¹⁰ If the insured dies while the policy is in force, the life insurance company pays a specified amount of money to the beneficiaries of the policy.

The cost of the risk coverage (the pure insurance cost of the policy) is determined roughly in the manner indicated by the following example.

9. Although the Tax Court spoke of the ratio of premiums paid by the insured and by the assignee to the total premiums paid on the policy, it seems clear that the Tax Court meant to refer to the ratio of premiums paid by the insured before or after the assignment and the premiums paid by the assignee (or someone else) after the assignment. The difference between the two formulations made no difference in the *Silverman* case itself, because the insured paid all of the premiums that became due before the assignment and the assignee paid all of the premiums that became due after the assignment.

10. Because there is no legal obligation to pay the premiums on a life insurance policy, the policy can be terminated at any time.

Suppose that a person of x age and in good health wishes to acquire \$1,000 of life insurance for a one-year period. The insurance company's actuarial tables indicate that 1% of persons of x age will die during that year. Thus, a premium charge of approximately 1% (\$10) will cover the risk of death for that year. But the company will pass on management and selling expenses, and will charge a somewhat higher premium. If the insurer is a profit-making stock company, the premium may also include an allowance for the company's profit. If the insurer is a mutual company,¹¹ the company will charge a larger premium than it reasonably expects to need and at the end of each year will return the excess amount over its actual needs to the policyholders as a so-called "dividend."¹² Policies that pay such "dividends" are called "participating insurance." While participating insurance is commonly offered by mutual companies, it is also offered by some stock companies.

Pure insurance coverage for a stated term is called "term insurance." In the case of the insured of x age, the annual premium of a \$1,000 one-year term policy was \$10 plus. If the insured should wish to continue that coverage for an additional year, the premium cost will be higher, since the percentage of persons $x + 1$ years of age who are projected to die during the year is greater than the percentage of persons only x years of age. Thus, each year the premium cost of the term insurance will increase. Term insurance typically is issued for a specific term such as five years, with an automatic renewal for an additional five years at the end of each term.¹³ The premium cost of the insurance, however, will increase as the insured ages. If the insured attains an advanced age, the premiums will become quite costly.

If the insured wishes to have insurance for more than one year but seeks to avoid this steady increase in the annual premium, the insured can purchase life insurance for a term consisting of a substantial number of years and pay the same amount of premium each year for a decreasing amount of insurance. The annual premium payments will remain constant, but every few years the amount of insurance coverage will be reduced. This variation of term insurance is called "declining term life insurance."

A second type of life insurance is ordinary life, frequently called "straight life" or "whole life." Ordinary life insurance combines the purchase of pure risk coverage with an investment. Part of the premium is charged to the pure insurance coverage of the policy (including the company's expenses) and part of the premium is treated as an investment by the policyholder with the insurer. The investment portion is referred to as the policyholder's

11. A mutual company has no stockholders and passes its earnings on to its policyholders and to certain beneficiaries of matured policies.

12. See *infra* notes 21-22.

13. Because the policyholder can terminate a policy at any time, the policyholder need not accept the renewal.

“reserve,” or “terminal reserve,” or “equity reserve” in the policy. The reserve is an equity interest that typically appreciates in value each year at a fixed rate established in the insurance contract.¹⁴

In the first few years of an ordinary life policy, the policyholder obtains little or no reserve in the policy because most of the early premiums are used to pay the company’s expenses, including selling commissions. After this initial period, the reserve increases each year, both because of appreciation in the established reserve and because of the policyholder’s payment of additional premiums. Since the amount payable at death is typically a fixed dollar figure (or a minimum amount), the amount of insurance risk coverage purchased by the policyholder is the difference between the amount payable at death and the policyholder’s reserve. Since the reserve, representing the policyholder’s equity, increases each year, the policyholder actually purchases less insurance each year, resulting in premiums that remain at a constant level. In effect, the policyholder has combined an investment program providing a secure (but often relatively low) rate of return with declining term life insurance coverage.

A policyholder has the right to borrow against the reserve or to surrender the policy for its cash surrender value. Because of administrative costs, the cash surrender value is slightly less than the policyholder’s reserve. The cash surrender value of a nonvariable ordinary life insurance policy can typically be determined from tables included in the policy. After approximately five years from the date a policy is taken out, the cash surrender value will usually be only slightly less than the policyholder’s reserve and can be used as an approximation of the reserve for planning purposes. Upon request, the insurer will provide the policyholder with a statement of the current value of the reserve. In the case of variable life insurance, the insurer’s statement will be the only means of obtaining a valuation.

On the death of the insured, the proceeds of the policy are payable according to the method of settlement elected by the owner of the policy or by the beneficiary. The various methods available for settling the proceeds of a matured life insurance policy are referred to as “settlement options.” These settlement options, typically elected by the beneficiary after the insured’s death, permit an election either to have the insurance proceeds paid in one

14. A variation of ordinary life is “variable life insurance.” It is similar to ordinary life insurance, except that it may not guarantee a specified return. The policyholder’s reserve and the death benefit may vary from year to year according to the relative success or failure of the insurer’s investment program. A guaranteed minimum death benefit is, however, typically provided.

lump sum or to have the insurance company retain the proceeds and pay them out under one of a variety of plans.¹⁵

Three economic components of life insurance emerge from the above description of life insurance: (1) the *term insurance coverage component* (coverage against the risk of the insured's death within the period covered by the last premium paid); (2) the *right of continuation component* (the right to continue having insurance coverage at a fixed price, regardless of the insured's health, beyond the period covered by the last premium); and (3) the

15. Some of the most common options are:

(a) *Interest only or deposit option*—interest is paid currently to the beneficiary, who is empowered to change to some other settlement option (including a lump sum payment). Some policies require the beneficiary to make a change of election within some stated period of time after the insured's death, but most policies permit the change of election to be made at any time. The purpose of the deposit option is to provide interest on proceeds left with the insurer while the beneficiary decides which settlement to elect.

(b) *Fixed period option*—the proceeds are paid out in installments of no less than a specified amount over a fixed period of time. If the policy earns more than a minimum guaranteed interest for any installment period, the amount of installment payment made to the beneficiary for that period will be increased accordingly.

(c) *Fixed amount option*—the proceeds are payable in a specified minimum number of installments of a fixed amount. If the policy earns more than the guaranteed minimum income, the number of payments is increased but the amount of each installment payment remains constant.

(d) *Straight life annuity*—a periodic payment of a fixed dollar amount to be made during the life of the beneficiary. Recently, some life insurance companies have offered a variation of the straight life annuity called the "variable life annuity," under which the periodic payments will vary in amount according to the success of the company's investments.

(e) *Self and survivor annuity*—an annuity of a specified amount paid periodically for the life of the primary beneficiary and on his or her death, survived by a named secondary beneficiary, an annuity of a specified amount (which may be smaller than the primary beneficiary's annuity) will be paid to the secondary beneficiary for life.

(f) *Joint and survivor annuity*—an annuity for the joint lives of two beneficiaries and for the life of the survivor. (The term "joint and survivor annuity" is sometimes used to describe a self and survivor annuity option.)

(g) *Annuity with a refund or guaranteed payment*—a refund feature of an annuity provides that if less than a specified amount has been paid to the beneficiary or beneficiaries at the time of the death of the last annuitant, the difference is payable in one lump sum to some named person or persons. Another variation of this is an annuity option with a guaranteed payment feature which provides that payments will be made for no less than a specified period of time, regardless of when the beneficiaries die.

Although settlement options are not as flexible a vehicle as a trust, they are not entirely inflexible. For example, a fixed period option may provide for installment payments for part of the option period larger than other payments, although the size of the payments typically must be fixed at the time that the election is made.

equity or terminal reserve component. Of course, not all life insurance policies contain all three components. Term insurance, for example, provides no equity for the policyholder. Nevertheless, it is important to keep these components in mind for they will be crucial to our analysis of the proper tax treatment that should be accorded to assignments of life insurance policies. To set the stage for this analysis, Part III describes the general framework of the current system of taxing life insurance.

III. THE GENERAL FRAMEWORK FOR TAXING LIFE INSURANCE

A. *Income Taxation of Life Insurance*

1. *Exclusion of Proceeds from Gross Income.*—In general, section 101 of the Internal Revenue Code excludes life insurance proceeds from the beneficiary's gross income.¹⁶ The exclusion is straightforward when the proceeds are payable in one lump sum.

The exclusion becomes somewhat complicated when the pay-out is governed by one of the settlement options providing for the retention of the proceeds by the insurer. Interest paid to a beneficiary on proceeds held by the insurer is included in the beneficiary's gross income.¹⁷ In the case of installment payments,¹⁸ the interest portion of the payment is included in the beneficiary's gross income, but the portion of the installment payment that is characterized as principal is excluded.¹⁹ Typically, the "principal" portion of an installment payment is a percentage of the face amount of the insurance. The same proportion of each installment payment is excluded at least until the aggregate of the excluded amounts exceeds the face amount of

16. One important exception to the exclusion is the "transferee for value" rule. If the person owning a life insurance policy on the death of the insured had acquired it for valuable consideration from someone other than the insurer, the amount of proceeds excluded from gross income is limited to the consideration, premiums, and certain other amounts paid by such person. See IRC § 101(a)(2). For policies issued after June 8, 1997, the reference to "other amounts" includes interest paid or accrued by the transferee on a debt incurred with respect to the insurance if such interest is not deductible because of IRC § 264(a)(4). This rule does not apply to a person who initially purchased the policy from the insurer, nor to a transferee of a policy who received it without consideration, provided that the transferor was not a transferee for value (or a transferee of a transferee for value). See Regs. §§ 1.101-1(b)(3)(iii), 1.101-1(b)(5) ex. (4). Even if a transferee acquired the policy for valuable consideration, the transferee for value rule is *not* applicable if the transferee was the insured, a partner of the insured, a partnership in which the insured is a partner or a corporation in which the insured is a shareholder or officer. See IRC § 101(a)(2)(B).

17. See IRC § 101(c).

18. Typically, such payments are made under an annuity, fixed amount, or fixed period option. See *supra* note 15. Special rules apply to certain life insurance policies that were issued before 1985 (or before 1983 in certain cases). See IRC § 101(f).

19. See IRC § 101(d)(1).

the policy, which occurs when a beneficiary of an annuity option outlives his or her life expectancy.²⁰

2. *Appreciation in Reserve.*—A policyholder's reserve or equity interest in an ordinary life insurance policy appreciates each year. Although the appreciation constitutes "earnings" from the policyholder's investment to the extent that the appreciation is not due to the payment of additional premiums, those "earnings" are not taxed to the policyholder.²¹ The rationale is that the income has not been "realized," or even "constructively received,"

20. If the transferee for value rule applies, however, the principal portion is not excluded from gross income. See *supra* note 16.

It is currently unclear whether the principal portion continues to be excluded for payments received in excess of the face amount of the policy. Before the adoption of the Tax Reform Act of 1986, the principal portion continued to be excluded, even though the face amount of the policy had already been received by the beneficiary. The regulations still so provide. See Regs. § 1.101-4(c). Before 1986, the same rule of exclusion applied to annuity payments taxable under § 72. However, in the Tax Reform Act of 1986, Congress amended § 72 to limit the exclusion to the investment in the annuity contract. See IRC § 72(b)(2). While no explicit amendment was made to § 101, the question remains whether the amendment to § 72 implicitly amended § 101 as well.

21. If a policyholder owns a participating life insurance policy, the so-called "dividend" paid by the insurer to the policyholder each year is in fact a return of part of the premiums previously paid by the policyholder, and so such "dividends" are not included in the policyholder's gross income. See 1 J. Mertens, *The Law of Federal Income Taxation* § 7.08 (rev. ed. 1974) (citing Regs. § 1.72-11(b) (1960)); cf. Rev. Rul. 64-258, 1964-2 C.B. 134, obsoleted by Rev. Rul. 82-148, 1982-2 C.B. 401 (holding that such payments do not constitute an inurement of net earnings to the policyholders so that a tax exempt organization's distribution to its members of the "dividends" it received on policies insuring the life of its members did not disqualify the organization of its tax exempt status under IRC § 501(c)(10)). Even "dividends" remitted on paid-up policies—policies for which no further premium payments are due—are excluded from gross income because such dividends are in essence a reduction of premiums paid in prior years. See 1 J. Mertens, *supra*, § 7.08, at 18 n.35. If, however, the policyholder does not withdraw the dividends from the insurance company, but instead leaves them on deposit with the insurer to earn interest, the interest credited to the accumulated dividends is included in the policyholder's gross income; such interest is no different from interest credited to a savings account deposit. *Id.*

If a policyholder sells an insurance policy to a third party, the policyholder will recognize a gain on the sale only if the amount realized thereon exceeds the policyholder's basis in the policy. Since all of the premiums previously paid by the policyholder (less "dividends" received) are included in the policyholder's basis, the amount realized often will not exceed the seller's basis. The reason that the amount realized on a surrender of the policy often will be less than the policyholder's basis is that the policyholder is permitted to include in basis the portion of the premiums that was attributable to the purchase of the insurance coverage for a specified period. The policyholder's basis is not limited to the portion of the premium that constituted the policyholder's addition to the reserve. Under a special provision in IRC § 101(g), sales by an insured who is chronically or terminally ill of any part of a death benefit to a "viatical settlement provider" will not be taxed.

in the tax sense.²² Moreover, even though the face amount of the proceeds payable to the beneficiary upon the death of the insured includes this appreciation in the policyholder's equity, such proceeds are typically excluded from the gross income of the beneficiary by section 101.²³

B. *Gift Taxation of Life Insurance*

There is no statutory gift tax provision expressly dealing with the transfer of a life insurance policy or the payment of its premiums. Such transfers are dealt with under the general gift tax provisions applicable to all types of transfers.²⁴ The regulations do provide that if the insured irrevocably assigns an insurance policy to another, "[t]he insured has made a gift of the value of the policy" to the extent that the assignment exceeds the value of any consideration received by the insured.²⁵

The gift tax value of a life insurance policy is its replacement cost—the amount necessary to purchase a comparable policy from a company regularly engaged in selling insurance.²⁶ Although the value of a policy can be influenced by unusual provisions in the policy itself,²⁷ the value is not affected by any external facts such as the health of the insured at the time of the gift. If the insured's health were taken into account, it would be necessary to determine the health of the insured in the case of every assignment and to estimate the effect of the insured's health on the valuation question by resorting to medical evidence and actuarial expertise. Such inquiries would impose a great administrative burden on both the government and on taxpayers. Presumably believing the burden to be too costly, the Service has not taken the insured's health into account in valuing policies for gift tax purposes.²⁸

In some cases, such as the case of a policy that has been in effect for some time and upon which further premiums must be paid, the value of an insurance policy may not be readily ascertainable. In such cases, if the insurance is an ordinary life, nonvariable policy, the value of the gift is obtained by combining the amount of the terminal reserve of the policy at the date of the gift and the proportionate part of the last premium paid before the

22. See *Cohen v. Commissioner*, 39 T.C. 1055, 1062-64 (1963).

23. It should be recalled, however, that IRC § 101(a)(2)—the "transferee for value" provision discussed *supra* note 16—is an exception to this rule.

24. See IRC §§ 2511-2512.

25. Regs. § 25.2511-1(h)(8). Although the regulation only refers to a gift by the insured, a gift tax will be imposed on any donor of a life insurance policy, unless a section of the Code expressly provides otherwise.

26. See Regs. § 25.2512-6(a).

27. See *id.* See also Rev. Rul. 77-181, 1977-1 C.B. 272.

28. Nor has the Service taken the insured's health into account for estate tax purposes when a decedent dies owning a policy on the life of another.

date of the gift covering the period extending beyond that date.²⁹ If the insurance is a variable policy, the value can be obtained from the insurer. If the donor continues to pay premiums after assigning the policy, each premium payment is an additional gift.³⁰

All or a portion of a gift of a life insurance policy may be excluded from gift tax. Section 2503(b) provides that a donor is entitled to an annual exclusion (currently in the amount of \$10,000) for gifts, other than gifts of "future interests,"³¹ given to each donee. An outright gift of an insurance policy (as contrasted to a gift in trust) is treated as a gift of a present interest, even though the proceeds will not be collected until a future date.³² The

29. The Regulations give the following example:

Example (4). A gift is made four months after the last premium due date of an ordinary life insurance policy issued nine years and four months prior to the gift thereof by the insured, who was 35 years of age at date of issue. The gross annual premium is \$2,811.

The computation follows:

Terminal reserve at end of tenth year	\$14,601.00
Terminal reserve at end of ninth year	<u>12,965.00</u>
Increase	\$ 1,636.00
One-third of such increase (the gift having been made four months following the last preceding premium due date), is	\$ 545.33
Terminal reserve at end of ninth year	<u>12,965.00</u>
Interpolated terminal reserve at date of gift	13,510.33
Two-thirds of gross premium (\$2,811)	<u>1,874.00</u>
Value of the gift	\$15,384.33

Regs. § 25.2512-6(a) ex. 4.

30. See Regs. § 25.2511-1(h)(8).

31. The term "future interest" has its own definition under the gift tax provisions and does not have the same meaning as it does under general property law. Any gift under which the donee's possession, use or enjoyment is postponed is a gift of a future interest. See Regs. § 25.2503-3(a). Note that beginning in 1999, the \$10,000 exclusion figure will be increased annually to reflect inflation. IRC § 2503(b)(2).

If the donor is married and the donor's spouse consents to split the donor's gifts between them under IRC § 2513, the \$10,000 available annual exclusion for the donor's gifts to a third party (someone other than the donor's spouse) may be doubled to \$20,000. If a gift is made to the donor's spouse, only \$10,000 can be excluded, but the balance of the gift may qualify for a marital deduction.

32. In Rev. Rul. 55-408, 1955-1 C.B. 113, the Commissioner repudiated a suggestion made by the Tax Court in *Nashville Trust Co. v. Commissioner*, 2 T.C. Memo (CCH) 99 (1943), that a gift of a policy before it had built up any cash surrender value was a gift of a future interest. See also Regs. § 25.2503-3(a). It should be noted, however, that if the gift is subject to a limitation which restricts the donee's right to reassign the policy, obtain its cash surrender value or borrow against its terminal reserve, then the donated property constitutes a future interest, and no annual exclusion can be claimed. See *Ryerson v. United States*, 312 U.S. 405, 408-09 (1941); *Skouras v. Commissioner*, 188 F.2d 831 (2d Cir. 1951); *Smyth v. Commissioner*, 2 T.C. Memo (CCH) 4 (1943).

annual exclusion can also apply to premium payments subsequently made by the donor.³³ If a life insurance policy is assigned to a trustee, however, the gift of the policy and any subsequent premiums paid by the donor likely will not qualify for the annual exclusion.³⁴ A gift of a life insurance policy or the payment of premiums on a policy owned by another may also be exempt from gift taxation if the gift qualifies for the gift tax charitable or marital deduction.³⁵

C. Estate Taxation of Life Insurance

1. *In General.*—Upon the insured's death, the proceeds paid to the beneficiaries are composed of two elements: the policyholder's equity interest in the policy and a death benefit payment (an amount representing the proceeds of the risk coverage element of the policy).³⁶

If the proceeds are payable to the insured's executor, section 2042(1) requires the proceeds to be included in the insured's gross estate, even if the policy was owned by another at the insured's death. Application of this provision, while not free of ambiguity, has not been especially troublesome. In general, the reference to the insured's "executor" means payable to or on behalf of the insured's estate.³⁷

If the proceeds are payable to someone other than the insured's executor, section 2042(2) requires the proceeds to be included in the insured's gross estate if the insured possessed, at death, any "incidents of ownership" in the policy. Although the Code makes no attempt to define "incidents of ownership," the regulations provide that the term is not limited to actual dominion over the policy, but also includes a lesser economic interest or benefit, such as the right to surrender or cancel the policy, change the named beneficiary, or pledge the policy for a loan.³⁸

33. See Rev. Rul. 76-490, 1976-2 C.B. 300; Rev. Rul. 55-408, 1955-1 C.B. 113.

34. See Kahn & Waggoner, *supra* note 1, at 954. But see Rev. Rul. 76-490, 1976-2 C.B. 300.

35. See IRC §§ 2522, 2523.

36. See, e.g., *United States v. Bess*, 357 U.S. 51, 59 (1958); *Old Kent Bank and Trust Co. v. United States*, 430 F.2d 392, 395-96 (6th Cir. 1970). This view of insurance conforms with the actuarial justification for the size of premiums charged for a policy, which is that the premiums are sufficient only to purchase risk coverage for the difference between the face amount of the policy and the policyholder's equity. See *supra* text accompanying notes 10-11.

37. See Regs. § 20.2042-1(b).

38. See Regs. § 20.2042-1(c)(2). The term also includes "a reversionary interest in the policy or its proceeds, whether arising by the express terms of the policy or other instrument or by operation of law, but only if the value of the reversionary interest . . . exceeded 5 percent of the value of the policy." Regs. § 20.2042-1(c)(3).

2. *Transfers Within Three Years of Death.*—Section 2035 operates in conjunction with section 2042 to impose an estate tax on life insurance proceeds when an insured assigns a policy to another within three years of death.

Before 1976, the estate and the gift tax statutes operated independently.³⁹ Each tax had its own structure, tax rates, exemptions, and other rules. Testamentary transfers were taxed separately from and more heavily than inter vivos gifts. The major reform implemented by the Tax Reform Act of 1976 was the integration of estate and gift taxation. The 1976 Act adopted a single transfer tax base, subjected that base to a comprehensive rate schedule, and reduced the tax produced by that schedule by a “unified credit.”⁴⁰

Under section 2035 as it existed before the 1976 Act, *all* gifts made within three years of death (and in contemplation of death) were included in the donor’s gross estate at their death-time value.⁴¹ Although the 1976 Act continued section 2035’s application to all gifts within three years of death, a byproduct of integrating the estate and gift taxes was to remove much of the purpose for subjecting all such gifts to the estate tax, especially since the 1976 Act also introduced a gross-up rule under which any gift tax paid on a gift within three years of death was brought into the donor’s gross estate.⁴² Under the integrated system, the only tax saving that would be produced by a gift of property that otherwise would have been included in the donor’s gross estate under section 2033 would be to exempt the post-gift appreciation on the property from transfer taxation.

The integration of estate and gift taxes did not, however, eliminate all potential for using death bed transfers to reduce transfer taxes. A potential for abuse continued to exist for a gift of an item whose retention would have

39. See Douglas A. Kahn et al., *Federal Taxation of Gifts, Trusts and Estates* 1-8, 387-91 (3d ed. 1997).

40. See *id.*

41. More precisely, such gifts were included at their estate tax value. Ordinarily, the decedent’s gross estate is valued at its death-time value, but it might be valued at a date up to six months after the decedent’s death if the executor elects the alternate valuation method under IRC § 2032. In this article, we refer to the death-time value because the estate tax value of a life insurance policy equals the value of its proceeds, which is its death-time value even if the alternate valuation method is elected.

42. More precisely, this provision requires inclusion of the gift tax paid by the decedent (or by the decedent’s estate) on any gift made by the decedent or by the decedent’s spouse within three years of the decedent’s death. See IRC § 2035(b). This provision was originally set forth in § 2035(c) prior to the amendment made by the Taxpayer Relief Act of 1997. The purpose of adding this provision was to eliminate the incentive for making deathbed taxable gifts in order to exclude the resulting gift tax payments from the donor’s transfer tax base. See H.R. Rep. No. 1380, 94th Cong., 2d Sess. 14 (1976).

caused a much larger amount than would result from ordinary post-gift appreciation to be included in the donor's gross estate than the item's current value, most notably a gift of a life insurance policy.

The 1976 Act could therefore have limited the scope of section 2035 by making it applicable only to transfers having the potential for abuse. But it did not. Instead, the 1976 Act expanded the scope of section 2035. Before 1976, section 2035 required the inclusion in a decedent's gross estate of the value of all property, including life insurance, given away by the decedent within three years of death, but only if the transfer was made in contemplation of death. The 1976 Act eliminated the contemplation of death requirement. As revised in 1976, section 2035 required the inclusion of all gifts made within three years of death, regardless of motive.

The Economic Recovery Tax Act of 1981 made section 2035 no longer applicable to *all* gifts within three years of death.⁴³ The 1981 Act confined section 2035 to what we call "tainted gifts"—gifts of an interest in or power over property that would have been included in the decedent's gross estate under sections 2036 through 2038 or section 2042 had the transfer not taken place.⁴⁴ The 1981 Act also retained the provision pertaining to the

43. See IRC § 2035(a). This narrowing of the scope of § 2035 was originally set forth in § 2035(d)(1) prior to the amendment made by the Taxpayer Relief Act of 1997. For an article urging Congress to return § 2035 to the form it took under the 1976 Act, under which *all* gifts within three years of death were included in the donor's gross estate, see Jeffrey G. Sherman, *Hairsplitting Under IRC Section 2035(d): The Cause and the Cure*, 16 Va. Tax Rev. 111 (1996).

44. See IRC § 2035(a)(2). This provision was originally set forth in § 2035(d)(2) prior to the amendment made by the Taxpayer Relief Act of 1997. In general terms, IRC § 2036 includes in the gross estate transfers with a retained life estate, § 2037 includes transfers with a retained reversionary interest, and § 2038 includes transfers with a power to alter, amend, revoke, or terminate. The inclusion of § 2038 in § 2035's list of tainted gifts was probably unnecessary, since § 2038 itself already provided that a relinquishment of the power to alter, amend, revoke, or terminate within three years of death causes the full value of the property to be included in the decedent's gross estate. See IRC § 2038(a)(1).

Congress should reconsider its decision to classify a gift of a retained life estate or a relinquishment of a power to revoke within 3 years of death as a tainted gift to which § 2035 applies. Under IRC § 2702, added to the Code in 1990, a transfer to a family member with a retained life estate subjects the full value of the property to gift taxation, not the value of the remainder interest. The original transfer, whether within or more than 3 years before death, is in effect treated as an outright gift with no strings attached. Under Regs. § 25.2511-2, a relinquishment of a power to revoke, whether within or more than three years before death, subjects the full value of the property to gift taxation.

Because the question of whether Congress should amend § 2035 to remove these types of gifts from the tainted gift category is beyond the scope of this article, we do not discuss the question further. For a more complete discussion of this question, see Sherman, *supra* note 43, at 148-51.

inclusion of the gift tax on *all* gifts within three years of death.⁴⁵

Congress restyled and reorganized section 2035 in the Taxpayer Relief Act of 1997. Although Congress largely retained the substance of the 1981 revisions, it shifted the wording in a subtle but significant way. As reformulated in 1997, section 2035 straightforwardly includes the amount that would have been included had the tainted gift not been made.⁴⁶ The preceding version was less clear regarding how the amount to be included was to be calculated.⁴⁷

In sum, although section 2035 has undergone significant change over the years, the need for section 2035 to prevent evasion of section 2042 has remained constant.

IV. ASSIGNMENT MORE THAN THREE YEARS BEFORE DEATH

If, more than three years before death, an insured assigns to another all incidents of ownership in a life insurance policy (whether the assignment is made outright or in trust), the proceeds of the policy will not be included in the insured's gross estate, provided that the insured does not retain or subsequently acquire (directly or indirectly) any incident of ownership in the policy. Section 2035 does not apply since, on its terms, that provision only covers transfers made within three years of death. The assignment is, of course, subject to the gift tax, except to the extent that the assignment qualifies for the gift tax annual exclusion or the marital or charitable

45. See *supra* note 42.

46. As revised in 1997, IRC § 2035 provides that "if (1) the decedent made a transfer (by trust or otherwise) of an interest in any property, or relinquished a power with respect to any property, during the 3-year period ending on the date of the decedent's death, and (2) the value of such property (or an interest therein) would have been included in the decedent's gross estate under section 2036, 2037, 2038, or 2042 if such transferred interest or relinquished power had been retained by the decedent on the date of his death, [then] the value of the gross estate shall include the value of any property (or interest therein) which would have been so included." (Emphasis added.)

The Taxpayer Relief Act of 1997 is applicable to estates of decedents dying after August 5, 1997. In this article, we sometimes refer to the law existing before the effective date of the 1997 Act as "pre-1998" law, though the 1997 Act does apply to part of 1997.

47. The language of the preceding version was generally read to include an amount calculated by determining the death-time value of the donated property. As revised in 1981, § 2035 provided in effect that *if* the decedent transferred "an interest in property which is included in the value of the gross estate under section 2036, 2037, 2038, or 2042 or would have been included under any of such sections if such interest had been retained by the decedent," *then* "the value of the gross estate shall include the value of all [such] property to the extent of any interest therein of which the decedent has at any time made a transfer, by trust or otherwise, during the 3-year period ending on the date of the decedent's death." (Emphasis added.)

deduction. Except to the extent excludible or deductible, the value of the gift is also included in the insured's estate tax base as an "adjusted taxable gift."⁴⁸

A. *Payment of Premiums by the Insured*

If, after assigning a policy to another more than three years before death, the insured continues to pay the premiums, those payments are subject to the gift tax, except to the extent that they are excluded by the annual exclusion or deductible under the marital or charitable deduction. Any such premium payments that are not excludible or deductible are also included in the insured's estate tax base as "adjusted taxable gifts."⁴⁹

The question of the amount includable under section 2035 because of premium payments made by the insured within three years of death, once a controversial issue, has been settled for some years now. The nature of this controversy and its ultimate resolution bear on the question of the merits of the *Silverman* approach, which is the focus of this article. We now turn to that issue.

B. *Premium Payments as a Constructive Transfer of a Portion of a Policy*

In 1967, in Revenue Ruling 67-463,⁵⁰ the Commissioner ruled that the insured's gross estate included that proportion of the insurance proceeds equal to the ratio that the amount of premiums paid by the insured within three years of death bore to the aggregate amount of premiums paid on the policy. The theory was that an insured's payment of a premium on a life insurance policy owned by another—in this case, the person to whom the insured had previously transferred the policy—constituted a transfer to the policyholder of a proportionate interest in the underlying policy.⁵¹

Revenue Ruling 67-463 relied on the 1929 decision of the Supreme Court in *Chase National Bank v. United States*.⁵² In *Chase*, the insured had

48. See IRC § 2001(b). If the assignment was made to someone other than the insured's spouse, and the insured and his or her spouse elected to split the gift under IRC § 2513, then only the insured's one-half share (less the annual exclusion, if any) is included in the insured's adjusted taxable gifts. The other half (less any annual exclusion allowed to the nondonor spouse) will be included in the estate tax base of the nondonor spouse on that spouse's death.

49. If split gift treatment under IRC § 2513 was elected for such payments (see *supra* note 48), the portion of the payments attributable to the insured's spouse is excluded from the insured's adjusted taxable gifts. See IRC § 2001(b).

50. 1967-2 C.B. 327 (revoked by Rev. Rul. 71-497, 1971-2 C.B. 329).

51. *Id.* The position adopted by the Commissioner in 1967 applied only to premium payments made in contemplation of death. As noted in the text, the 1976 Act eliminated the contemplation of death requirement.

52. 278 U.S. 327 (1929).

purchased life insurance in which he named his wife as beneficiary and retained incidents of ownership until his death. The insured, who died within two years of purchasing the insurance, had paid all premiums due on the policies. The insured's estate challenged the constitutionality of the statute (the antecedent of section 2042(2)) that subjected the insurance proceeds to estate taxation. The estate contended that the tax was one on property itself, and therefore an unconstitutional unapportioned direct tax, rather than a tax on a "transfer" of property. This was so, the estate argued, because the insured had never transferred the proceeds to the beneficiary. Rather, the beneficiary had acquired the proceeds directly from the insurer.⁵³

In upholding the validity of the tax, the Supreme Court held that in substance the insurance proceeds had been transferred by the insured to the beneficiary, since his instruction to the insurer to pay the proceeds to his wife constituted a procurement of the proceeds by him for delivery to his wife. The Court determined that a person who purchases property from another to be delivered to a third party is to be treated as having transferred that property to the third party, and indicated that this principle would apply in interpreting the word "transfer" in the Code as well as in deciding the constitutionality of a particular provision.⁵⁴

The courts, however, uniformly rejected the Commissioner's attempt to apply the *Chase* holding to premiums paid within three years of death on a policy that the insured had irrevocably transferred to another more than three years before death.⁵⁵ The courts did not repudiate the Supreme Court's construction of the word "transfer," but held it inapplicable to the payment of premiums on a policy owned by another. The clearest statement of the rationale for rejecting the Commissioner's position⁵⁶ was given by the Fifth Circuit in *First National Bank v. United States*.⁵⁷

53. Id. at 334.

54. Id. at 337-38.

55. See *First Nat'l Bank v. United States*, 423 F.2d 1286, 1288 (5th Cir. 1970); *Gorman v. United States*, 288 F. Supp. 225, 228-31 (E.D. Mich. 1968); *Estate of Coleman*, 52 T.C. 921, 923-24 (1969). See also *Estate of Chapin*, 29 T.C. Memo (CCH) 11, 15-16 (1970); Lowndes & Stephens, Identification of Property Subject to the Federal Estate Tax, 65 Mich. L. Rev. 105, 124-25 (1966); Note, Section 2035 as a Basis for Including Life Insurance Proceeds in the Gross Estate of an Insured Who Paid Premiums on a Policy Owned By Another Person, 67 Mich. L. Rev. 812 (1969).

56. Even if the Commissioner had prevailed in arguing that there was a constructive transfer of a portion of the insurance proceeds, the portion includible should not have been figured on the basis of the Commissioner's formula. The Commissioner's formula undoubtedly was derived from the old payment of premiums test that Congress eliminated from IRC § 2042 in 1954. The failings of the premium payment test are discussed in Kahn & Waggoner, *supra* note 1, at 970-75.

57. 423 F.2d 1286 (5th Cir. 1970).

The actual essence of the Government's position is that it wishes to place a decedent who pays the premiums on a policy owned by another on the same footing with one who physically transfers the policy itself. It is said that the . . . [policyholders] received insurance benefits and not cash and that the payment of each and every premium helped to produce the proceeds. The answer to this, however, . . . [is] that the rights maintained belonged to the owners, not to the decedent, and were thus neither transferred nor transferrable by the decedent.⁵⁸

After losing every litigated case on this issue, the Commissioner reconsidered his original position and issued Revenue Ruling 71-497, which revoked the 1967 ruling and conceded that only the dollar amount of premiums paid by the insured within three years of death would be included in the insured's gross estate.⁵⁹ This latter portion of Revenue Ruling 71-497 was made obsolete by the 1981 amendments of section 2035.⁶⁰ For decedents dying after 1981, premium payments made by an insured within three years of death are subject to the gift tax but are no longer includible in the insured's gross estate, though any gift tax paid on such premium payments is includible.⁶¹

V. ASSIGNMENT IN SUBSTANCE WITHIN THREE YEARS OF DEATH

Revenue Ruling 71-497⁶² dealt with another issue—the purchase of an insurance policy for another within three years of death. Under the facts considered in this portion of the ruling, the insured, nine months before he died from accidental causes, purchased a one-year term accidental death policy insuring his life. The insured's children were designated as the *owners* as well as beneficiaries of the policy. Although the insured never actually possessed an incident of ownership in the policy, the Commissioner ruled that under section 2035, the entire proceeds were includable in the insured's gross

58. 423 F.2d at 1288, accord *Bintliff v. United States*, 462 F.2d 403, 406 (5th Cir. 1972).

59. 1971-2 C.B. 329, revoking Rev. Rul. 67-463, 1967-2 C.B. 327. In Rev. Rul. 71-497, the premiums were paid on both an ordinary life insurance policy and on a term life insurance policy.

60. None of the exceptions discussed *supra* in the text accompanying notes 43 through 45 apply.

61. See IRC § 2035(b). Also, any premium payments that constituted a gift will be included in the donor's adjusted taxable gifts to the extent not covered by the annual exclusion or the marital or charitable deduction. See IRC § 2001(b).

62. 1971-2 C.B. 330.

estate. The Commissioner's theory was that the insured had transferred ownership of the policy to his children and had not merely paid a premium on a policy that they owned. The Commissioner again relied on the *Chase National Bank* case, and this time, until section 2035 was amended in 1981, the Commissioner's position was sustained by the courts, initially in a decision of the Fifth Circuit, *Bel v. United States*.⁶³

In *Bel*, the insured had used community funds each year to purchase a one-year term accidental death policy in the name of his three children.⁶⁴ The insured died within ten months of acquiring the last policy.⁶⁵ Referring to the *Chase National Bank* opinion and relying on section 2035 rather than section 2042, the Fifth Circuit treated the insured as having assigned the policy itself to his children within three years of death and accordingly included half of the proceeds (the insured's community share) in his gross estate.⁶⁶ While explicitly recognizing that the insured never possessed any incident of ownership, the court concluded:

[S]ection 2042 and the incidents-of-ownership test are totally irrelevant to a proper application of section 2035. We think our focus should be on the control beam of the word "transfer." The decedent, and the decedent alone, beamed the accidental death policy at his children, for by paying the premium he designated ownership of the policy and created in his children all of the contractual rights to the insurance benefits. These were acts of transfer. The policy was not procured and ownership designated and designed by some goblin or hovering spirit. Without [the decedent's] conception, guidance, and payment, the proceeds of the policy in the context of this case would not have been the children's. His actions were not ethereally, spiritually, or occultly actuated. Rather, they constituted worldly acts which by any other name come out as a "transfer." Had the decedent, within three years of death, procured the policy in his own name and immediately thereafter assigned all ownership rights to his children, there is no question but that the policy proceeds would have been included in his estate. In our opinion the decedent's mode of execution is functionally indistinguishable. Therefore, we hold that the action of the decedent constituted a "transfer" of the

63. 452 F.2d 683 (5th Cir. 1971).

64. See *id.* at 686.

65. See *id.*

66. See *id.* at 691-92.

accidental death policy within the meaning of section 2035, and that the district court erred in failing to include [the decedent's] community share of the proceed value of the policy in his gross estate.⁶⁷

The position adopted in *Bel* is sometimes referred to as the “constructive transfer principle” or as the “beamed transfer principle.” As a consequence of the 1981 amendment to section 2035, the courts subsequently repudiated the constructive transfer principle. The Commissioner also accepted that it is no longer valid.⁶⁸ Although we later discuss (and decry) the rejection of the constructive transfer principle to original purchases of policies in the name of another, we first defend the inapplicability of that principle to payments of insurance premiums on policies owned by another.

A. *The Proper Boundary of the Constructive Transfer Principle*

As previously noted in Part IV, even before the repudiation of the constructive transfer principle, the courts had rejected its application to payments of insurance premiums on policies owned by another, but accepted its application to original purchases of policies in the name of another. In each case, the donor purchased something of his or her choosing from the insurance company for the donee. From this standpoint, both cases are quite different from a situation clearly outside the proper boundary of the constructive transfer principle, for example, where the donor gives cash to a donee to do with it as the donee sees fit. It should be equally clear that, prior to its repudiation, the constructive transfer principle was fully warranted in the case of an original purchase of a policy for a donee. Indeed, it would be difficult to think of a case that would fall more clearly within the proper boundary of that principle.⁶⁹

Why then, while the constructive transfer principle was still valid, did the situation where an insured paid premiums within three years of death on a policy owned by another not also fall within the proper boundary of that

67. *Id.* at 691-92.

68. See *infra* text accompanying notes 77-78.

69. Prior to 1981, other situations were held to fall within the constructive transfer principle. For example, when a decedent “had” his wife apply for term insurance on the decedent’s life and subsequently paid the policy premiums, the decedent was deemed to have transferred the policy to his wife. See *First Nat’l Bank v. United States*, 488 F.2d 575 (9th Cir. 1973). Similarly, when a decedent created an irrevocable trust, directed the trustee to acquire \$100,000 of insurance on the decedent’s life out of cash transferred to the trust, and died within six months thereafter, the decedent was deemed to have transferred the \$100,000 policy to the trustee. See *Detroit Bank & Trust Co. v. United States*, 467 F.2d 964 (6th Cir. 1972). See also *Estate of Kurihara v. Commissioner*, 82 T.C. 51 (1984) (reviewed by the Court).

principle? Simply put, the reason is that the item of property that the donor acquired for the donee when purchasing an insurance policy for the donee, a situation where the constructive transfer principle previously applied, is an item of property that the donor could have acquired and then given to the donee. But when an insured pays the premiums on a policy already owned by the donee, the donor's premium payment does not purchase items of property that the *donor* could have acquired and then transferred to the donee. Only the donee, the policyholder, owns the right to keep the policy in force, and thus is the only person in whose name the term insurance coverage⁷⁰ can be continued and who can benefit from the increase in the equity reserve in the policy resulting from the premium payment made by the donor. In the words of the Fifth Circuit in *First National Bank*, these property interests were not "transferable by the decedent."⁷¹

Holding that the insured's payment of premiums on a policy owned by another is outside the boundary of the constructive transfer principle conforms to the policy underlying section 2035. That section was aimed at capturing in a decedent's gross estate property that would have been included had the decedent not made a transfer shortly before death. If the insured possessed no incidents of ownership in a policy within three years of death, the proceeds would not be included in the decedent's gross estate regardless of whether the premiums were paid or not.⁷² The gift of the premium payments therefore do not remove an item (the proceeds) from the decedent's gross estate since the item would not be part of the decedent's gross estate in any event.

Since the premium payments do remove the dollar amount of those payments from the decedent's gross estate, the pre-1982 version of section 2035 captured all or part of those premium payments in the decedent's gross estate. As a result of the 1981 amendment of section 2035, the premium payments are no longer captured by that provision. The integration of estate and gift taxes made it irrelevant that the dollar amount of the premium payments themselves were removed from the decedent's holdings during life rather than transferred at death.

The 1997 amendment of section 2035 makes it even more obvious that the insured's payment of premiums does not cause an inclusion of the

70. In this article, the phrase "insurance coverage" refers to the difference between the proceeds payable on the death of the insured and the policyholder's equity reserve in the policy.

71. See *First Nat'l Bank v. United States*, 423 F.2d 1286, 1288 (5th Cir. 1970).

72. However, if the proceeds were payable to the decedent's executor (i.e., payable on behalf of decedent's estate), the proceeds would be included in decedent's gross estate under IRC § 2042(1). In this article, we have not discussed that provision because it has no relevance to the issues at hand.

insurance proceeds. The current version of section 2035 applies to a transfer of life insurance within three years of death only when the insurance proceeds would have been included in the decedent's gross estate under section 2042 if the transfer had not taken place. Manifestly, if the insured possessed no incidents of ownership within three years of death, section 2042 would not operate regardless of whether the insured paid premiums during that period.

In sum, the now defunct constructive transfer principle was properly limited, at least insofar as section 2035 is concerned, to purchases in the name of the donee of property interests that the donor could have acquired.

B. *The Ill-advised Abrogation of the Constructive Transfer Principle*

Changes made by Congress to section 2035 in 1981 led three United States Courts of Appeals, one of which affirmed a unanimous decision by eighteen Tax Court judges, to abrogate the constructive transfer principle (as it had been applied in *Bel*). In *Estate of Perry v. Commissioner*,⁷³ the decedent, within three years of death, applied for two insurance policies by signing application forms as the person to be insured. The decedent's three sons signed the applications as the proposed policy owners. The decedent paid the only premium that fell due on one of the policies by a check drawn on his personal checking account. The decedent paid all of the premiums on the other policy, consisting of an initial premium paid by check drawn on his personal checking account and subsequent monthly premiums by pre-authorized withdrawals from his personal checking account.

In *Estate of Headrick v. Commissioner*,⁷⁴ the decedent, a tax attorney, within three years of death, drafted an irrevocable trust agreement that authorized, but did not require, the trustee to invest in life insurance policies on his life and to hold such policies as trust principal. The decedent selected a bank to act as trustee of the irrevocable trust. The bank president testified that based on a discussion with the decedent he believed that the decedent intended the trust to function as an "insurance trust for his family," although the decedent did not condition the establishment of the trust on the bank's commitment to acquire life insurance with the funds contributed to the corpus. After the trust was established, the bank, as trustee, completed an application for an insurance policy on the decedent's life. The application stated that the policy owner and the beneficiary would be the bank as trustee of the decedent's trust. The decedent signed the application as the insured.

73. 927 F.2d 209, 210-11 (5th Cir. 1991).

74. 918 F.2d 1263, 1264 (6th Cir. 1990), *aff'd* 93 T.C. 171 (1989) (unanimous, reviewed opinion).

The bank paid the premiums on the policy from funds that the decedent contributed to the trust.

In *Estate of Leder v. Commissioner*,⁷⁵ the decedent, within three years of death, signed an insurance application form as the insured and his wife signed the application as the owner. The premiums were paid by preauthorized withdrawals from the account of the decedent's wholly owned corporation. The corporation treated the premium payments as loans to the decedent.

The courts in all three cases reasoned that the 1981 amendment of section 2035 makes that section apply to life insurance proceeds only when section 2042(2) would have applied if the insured had retained an incident of ownership in the policy instead of transferring it. The courts concluded that section 2035 does not apply unless the insured once possessed an incident of ownership and transferred that incident within three years of death. If the original ownership of the policy was placed in someone other than the insured, the courts held that the fact that the insured had initiated the purchase of the policy and directly or indirectly paid the premiums is not enough to trigger the post-1981 version of section 2035.⁷⁶

In light of the unanimity of these decisions, the Commissioner conceded the issue in an Action on Decision.⁷⁷ In that AOD, the Commissioner asserted disagreement with the results in these cases, but decided not to litigate the issue any further. In several subsequent rulings, the Commissioner acknowledged that the constructive transfer principle is no longer valid.⁷⁸

Complete abrogation of the constructive transfer principle was ill-advised. The constructive transfer principle, which is merely an application of the widely-utilized substance-over-form doctrine, and is analogous to the indirect transfer doctrine recognized in the gift tax regulations,⁷⁹ should

75. 893 F.2d 237, 238 (10th Cir. 1989), *aff'g* 89 T.C. 235 (1987).

76. See *Perry*, 927 F.2d at 211-13; *Headrick*, 918 F.2d at 1265-68; *Leder*, 893 F.2d at 240-42.

77. See A.O.D. 1991-012 (Jan. 18, 1991) ("Although we continue to believe that substance should prevail over form and that such indirect transfers should be included in a decedent's gross estate, in light of the three adverse appellate opinions . . . , we will no longer litigate this issue.").

78. See Tech. Adv. Mem. 93-23-002 (Feb. 24, 1993); Tech. Adv. Mem. 91-41-007 (Jun. 19, 1991).

79. See Regs. § 25.2511-1(a). The regulation provides: "The gift tax applies to a transfer by way of gift whether the transfer is in trust or otherwise, whether the gift is direct or indirect, and whether the property is real or personal, tangible or intangible." *Id.* (Emphasis added.) Regs. § 25.2511-1(c)(1) explains: "The gift tax also applies to gifts indirectly made. Thus, any transaction in which an interest in property is gratuitously passed or conferred upon another, regardless of the means or device employed, constitutes a gift subject to tax." *Id.* (Emphasis added.)

continue to apply to cases in which, *in substance*, the insured acquired the policy and then assigned it, even though *nominally* the assignee initially acquired the policy. The insured's payment of premiums should not be a decisive element. Rather, the insured's premium payments should be just one datum of evidence suggesting that the insured was the actual acquirer of the policy. Other factors, such as whether the insured initiated the acquisition of the policy, should also be taken into account. This more restricted view of the constructive transfer principle had been adopted by the Tax Court before the doctrine was abrogated entirely.⁸⁰

By elevating the formal facts over the substance of what took place, the courts have opened a loophole in the system. It should not matter that the donee *nominally* acquired the newly issued policy from the insurer if the substance of the arrangement is that the insured instigated the acquisition and is the true purchaser behind the scenes. It also should not matter whether the insured was in good health when acquiring the policy because the initial purchase of a policy in the name of another is a hedge against increased estate tax liability if the insured dies prematurely, which should only be allowed to succeed if the insured outlives the initial purchase by more than three years.⁸¹ The abrogation of the constructive transfer principle allows

80. See, e.g., *Estate of Clay v. Commissioner*, 86 T.C. 1266, 1272-73 (1986); cf. *Schnack v. Commissioner*, 848 F.2d 933, 939-40 (9th Cir. 1988) (following *Clay*).

81. For a contrary argument, see Harrison S. Lauer, *Estate Taxation of Life Insurance Transfers: The Impact of the Tax Reform Act of 1976 Still Ignored Twelve Years Later*, 41 *Tax Law.* 683, 696, 730 (1988). Lauer's argument is that an insured must be in good health in order to acquire a policy and, consequently, only about half of the insureds who acquire a policy will die prematurely, the other half outliving their life expectancy. See *id.* at 716. Thus, he argues, this is not the type of situation to which § 2035 is properly addressed. He assumes that the only reason that the assignment of an existing policy within three years of death is brought back into the insured's gross estate under § 2035 is because at the time of assignment the insured's health might have deteriorated, even if assignment occurred one day after purchasing the policy, so that at death the insurance element of the policy will have appreciated substantially beyond its gift tax value at the time of assignment. See *id.* at 720-21.

Lauer's argument rests on several false assumptions. First, it is not always true that an insured must take a physical examination and be found to be in good health in order to acquire a life insurance policy. Employer-paid group term life insurance is usually provided to new employees without a physical. Secondly, there will be a time gap between taking a physical examination and the actual purchase of the policy, so that the insured's health might have deteriorated before purchasing the policy. Finally, and most importantly, application of § 2035 does not depend on a finding that the insured was in poor health at the time of assignment. Section 2035 is not based exclusively on a policy of preventing tax benefits from accruing to transfers made in anticipation of imminent death. Even the original "contemplation of death" rule referred to death motives for making the transfer, such as a potential reduction of estate tax liability, rather than to an anticipation of imminent death. A transfer of a policy by a healthy individual is a hedge against the possibility of premature death. The purpose of having another person own the policy is a further hedge designed to reduce the insured's estate

anyone contemplating the purchase and gift of a life insurance policy to structure the form, but not the substance, of the transaction to eliminate the risk of incurring estate tax on the full proceeds if death occurs within three years. Nothing in the legislative history suggests that Congress intended to open up such a loophole when it amended section 2035 in 1981. The issue likely is moot now, but the Commissioner might wish to reconsider the decision to concede the position taken by the Tax Court and the three courts of appeal.⁸²

VI. OUTRIGHT ASSIGNMENT WITHIN THREE YEARS OF DEATH

We now turn to a gift of a life insurance policy within three years of death by an insured who, before making the assignment, unquestionably owned incidents of ownership in the policy. Under section 2035 as reformulated by the Taxpayer Relief Act of 1997, the amount included in the decedent's gross estate is the amount that would have been included under section 2042 had the gift not been made.⁸³ (We sometimes call this the *what-would-have-been-included* method of calculating the amount includible.) Because section 2042 requires the full value of the proceeds to be included in the insured's gross estate if the insured possessed at death *any* of the incidents of ownership in the policy, the starting point is that a gift by the insured within three years of death of any incident of ownership requires inclusion of the full value of the proceeds under section 2035.

In 1981, Congress confined section 2035 to tainted gifts.⁸⁴ (A "tainted gift" is a gift within three years of death of an interest in or power over property that would have been included *under sections 2036 through 2038 or section 2042* had the gift not been made.) Before 1981, most of the litigation and rulings under section 2035 concerned nontainted gifts—gifts of property that would have been included in the donor's gross estate *under section 2033* had the gift not been made. The practice under the case law and rulings, supported by the language of the statute,⁸⁵ was to revalue the donated property *as of the date of death* and include that amount in the

tax liability in the case of premature death, which should be allowed to succeed only if the insured lives for more than three years.

82. See also Sherman, *supra* note 43, at 131-37.

83. See IRC § 2035(b); see also *supra* note 46. Any gift tax paid on the gift is also included. See IRC § 2035(b).

84. See *supra* text accompanying notes 43-44.

85. IRC § 2035 then provided that the decedent's gross estate includes "the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer . . . in contemplation of his death."

donor's gross estate.⁸⁶ (We sometimes call this the *death-time-value-of-the-gift* method of calculating the amount includible.)

We argue that even before the 1997 Act expressly adopted the what-would-have-been-included method, the use of that method for gifts of a life insurance policy would have avoided many difficulties and would have led to a more sound result.⁸⁷ We want to emphasize that using that method is not essential for a gift of a life insurance policy.⁸⁸ The old death-time-value-of-the-gift method, *properly applied*, would reach the correct result in the case of a gift of a life insurance policy within three years of death. The advantage of the new what-would-have-been-included method is that the correct result is much easier to recognize. In fact, even under the death-time-value-of-the-gift method, the courts and the Service did reach the correct

86. This practice sometimes proved troublesome. See, e.g., *Commissioner v. Estate of Gidwitz*, 196 F.2d 813 (7th Cir. 1952) (income generated by property transferred within three years of death not includible in donor's gross estate); Rev. Rul. 80-336, 80-2 C.B. 271 (death-time value of gift of stock within three years of death includes the value of post-gift stock dividends paid before death); Rev. Rul. 72-282, 72-1 C.B. 306 (value of gift included in donor's gross estate at its death-time value even though the donee had sold the donated property before the donor's death).

87. Even before Congress confined § 2035 to tainted gifts, the courts had at least indirectly recognized that the proper amount includible in the case of one type of tainted gift, a gift of a retained life estate within three years of death, was the amount that would have been included had the gift not been made—the full value of the property, not the death-time value of the then-expired life estate. See, e.g., *United States v. Allen*, 293 F.2d 916, 917-18 (10th Cir. 1961) (although the decedent sold her retained life income interest within three years of death for more than its value, the court held that the consideration received was not adequate for estate tax purposes because it was less than would have been included in her gross estate if the “sale” had not taken place); *Estate of D'Ambrosio v. Commissioner*, 101 F.3d 309, 312 (3d Cir. 1996) (citing *Allen* with approval). Also, well before Congress confined § 2035 to tainted gifts, Congress itself had expressly recognized that the proper amount includible in the case of another type of tainted gift, a relinquishment of a retained power to revoke within three years of death, is the amount that would have been included had the gift not been made—the full value of the property, not the death-time value of the then-expired power to revoke. Section 2038 of the Code has long expressly so provided. See IRC § 2038(a)(1) (applicable to transfers after June 22, 1936); IRC § 2038(a)(2) (applicable to transfers on or before June 22, 1936). The Tax Reform Act of 1976 substituted “during the 3-year period ending on the date of the decedent's death” for “in contemplation of . . . death.” See Tax Reform Act of 1976, Pub. L. No. 94-455, § 2001(c)(1)(K), 90 Stat. 1520, 1852-53 (1976). These express provisions in IRC § 2038 made the reference in § 2035 to § 2038 duplicative and unnecessary.

88. In contrast, use of the what-would-have-been-included method is essential for a gift of a retained life estate or relinquishment of a retained power to revoke because the death time value of the gift—the retained life estate or power to revoke—would be zero. See *supra* note 87. Note, however, the need for Congress to reassess its decision to classify a gift of a retained life estate or a relinquishment of a power to revoke within three years of death as a tainted gift to which § 2035 applies. See *supra* note 44.

result in cases in which no post-assignment premiums became due. The pre-1998 case law and rulings held that the full value of the proceeds was includible,⁸⁹ which is the same amount that would be includible under the new what-would-have-been-included standard.

It was principally when the assignee paid some or all of the post-assignment premiums that the case law faltered and reached an incorrect result. As noted earlier,⁹⁰ the leading case on the issue is *Estate of Silverman v. Commissioner*,⁹¹ a case decided by the Tax Court in 1973, before section 2035 was confined to tainted gifts,⁹² and long before the 1997 reformulation expressly adopted the what-would-have-been-included standard.

In *Silverman*, the insured, within six months of death, assigned a \$10,000 life insurance policy to his son. Before the assignment, the insured had paid the monthly premiums as they became due, but after the assignment, the insured's son paid the premiums. In total, \$3,261.20 in premiums were paid on the policy. Of these, the insured paid \$2,893 and the son paid \$368.20.

The Tax Court attempted to determine the death-time value of the insured's gift by using the ratio of premiums paid by the insured to the total premiums paid on the policy. Because the insured paid 88.71% of the premiums, the insured, in the Tax Court's view, only transferred 88.71% of the policy within three years of death. In consequence, the Tax Court held that only 88.71% of the proceeds should be included in the insured's gross estate:

[Because] the petitioner [the assignee of the policy] paid all the insurance premiums after the assignment . . . [,] we feel that the petitioner contributed to the value of the policy, and it would be inappropriate to include in the gross estate that portion of the value which petitioner contributed.

89. See *supra* text accompanying note 6.

90. See *supra* note 8.

91. 61 T.C. 338 (1973), *aff'd* on the limited grounds raised on appeal, 521 F.2d 574 (2d Cir. 1975). When *Silverman* arose, one of the requirements for including the proceeds of an assigned life insurance policy in the insured's gross estate was that the assignment have been made in contemplation of death as well as having been made within three years of death. In *Silverman*, the Tax Court found that the insurance policy, which had been assigned to the insured's son six months before the insured's death, had been assigned in contemplation of death. Congress eliminated the "contemplation of death" requirement when it amended the Code in 1976.

92. As explained earlier, a "tainted" gift is a gift within three years of death of an interest in or power over property that would have been included in the decedent's gross estate under §§ 2036 through 2038 or § 2042 had the transfer not taken place. See *supra* text accompanying note 44.

Throughout its existence, including the time of transfer, the policy had a face value of \$10,000. At the time of the decedent's death, however, a certain number of premiums were required to keep the face value intact. It is apparent, therefore, that at the time the decedent transferred the policy, only a portion of the premiums necessary to maintain the face value payment on death had in fact been paid. The petitioner's continued premium payments were thus a vital part of the consideration necessary to secure full payment on the insurance policy on decedent's death. *To hold otherwise would tax the estate on an asset greater than that which the decedent transferred.* . . . We are further bolstered in our decision by sec. § 20.2035-1(e), Estate Tax Regs., which states: "However, if the transferee has made improvements or additions to the property, any resulting enhancement in the value of the property is not considered in ascertaining the value of the gross estate." We therefore hold that the decedent's estate must include that portion of the face value of the life insurance policy which the decedent's premium payments bore to all premium payments.⁹³

The taxpayer appealed to the Second Circuit, contending that only the cash surrender value of the policy at the time of assignment (\$1,120) or the amount of premiums paid by the insured within three years of death (\$1,525) should have been included.⁹⁴ In response, the Commissioner merely urged the court to affirm the Tax Court's decision, but did not argue that the Tax Court's analysis was more favorable to the taxpayer than warranted. In dismissing the taxpayer's contention, the Second Circuit "freely admit[ted] some uneasiness"⁹⁵ about the Tax Court's use of the ratio of premium payments to calculate the amount includible. The circuit court noted that another possible approach would have been to include the full dollar value of the proceeds, reduced only by the dollar amount of the post-assignment premiums paid by the son.⁹⁶ Since the Commissioner had not challenged the Tax Court's analysis, however, the Second Circuit affirmed without developing the analytical argument for the position it seemed to favor.⁹⁷

93. 61 T.C. at 342-43. (Emphasis added.) We noted earlier that the Tax Court meant to refer to the ratio of premiums paid by the insured before or after the assignment and the premiums paid by the assignee (or someone else) after the assignment. See *supra* note 9.

94. 521 F.2d 574 (2d Cir. 1975).

95. *Id.* at 577.

96. See *id.* at 577-78.

97. See *id.* at 578.

Unfortunately, the Commissioner acquiesced in *Silverman* and applied the Tax Court's analysis in subsequent rulings and internal memoranda.⁹³ As a result, the issue has not been litigated since.⁹⁹

Although *Silverman* applied the old death-time-value-of-the-gift standard, not the new what-would-have-been-included standard, the Tax Court's view that each premium payment purchases a fractional share of the policy¹⁰⁰ cannot be completely dismissed as irrelevant. The Tax Court used the ratio of premiums paid by the insured to the total premiums paid on the policy to hold that the insured had only transferred 88.71% of the policy. The Tax Court bolstered its position by suggesting that the assignee's premium payments were in the nature of expenditures for improvements or additions to the property transferred. If the Tax Court's analysis were correct, then only 88.71% of the policy ought to be included even under the new what-would-have-been-included standard.¹⁰¹

The fallacy of *Silverman*, however, is the idea that the decedent only transferred a fractional interest in the policy. At the time of the transfer, which is when the property transferred should be determined, the decedent was the *sole* owner of the policy. The decedent was not a part owner. There was no co-owner. The decedent owned and transferred the entire policy.¹⁰²

98. The Commissioner acquiesced in the Tax Court's decision, see 1978-1 C.B. 2, and applied the *Silverman* analysis in A.O.D. 1978-113 (1978); A.O.D. 1978-114 (1978); Gen. Couns. Mem. 38,110 (Sept. 25, 1979); Tech. Adv. Mem. 79-07-011 (Oct. 27, 1978); Priv. Ltr. Rul. 87-24-014 (Mar. 11, 1987).

99. In *Estate of Friedberg v. Commissioner*, 63 T.C. Memo (CCH) 3080 (1992), the Service unsuccessfully sought to distinguish *Silverman*, not to overturn it. The insured had transferred his life insurance policy to his daughter within three years of death. The daughter paid the post-assignment premiums and was the beneficiary of the policy. Because the daughter served as the executor of the insured's estate, the Service argued that the full value of the proceeds was included under § 2042(1). The Tax Court held that the proceeds were payable to the insured's daughter in her individual capacity, not in her capacity as the insured's executor. Therefore, the Tax Court applied the *Silverman* proration approach to determine the amount includible in the insured's gross estate under § 2035.

100. "To hold otherwise," the Tax Court said, "would tax the estate on an asset greater than that which the decedent transferred." 61 T.C. at 343.

101. If a decedent-insured only owns a fractional interest in a policy at death, only that fractional interest of the proceeds is includible under IRC § 2042. See Regs. § 20.2042-1(c)(5), -1(c)(6).

102. The Tax Court's position in *Silverman* is reminiscent of the premium payment test that was once employed by the estate tax laws as part of the antecedents to § 2042(2). Under the premium payment test, which Congress repudiated in 1954, the estate of a deceased insured was required to include in the gross estate a percentage of the life insurance proceeds equal to the percentage of premiums that were paid by the insured. This test was properly eliminated by Congress when it adopted the 1954 Code. See Kahn & Waggoner, *supra* note 1, at 970-75.

As noted above, the Tax Court attempted to bolster its position by suggesting that the assignee's premium payments were in the nature of expenditures for improvements or additions to the property transferred. Were this a correct characterization, the death-time value of the improvement or addition would not be included in the decedent's gross estate because the decedent did not transfer the improvement or addition. After all, if the sole owner of a parcel of vacant land gave the land to a grantee who built a building on it, the death-time value of the gift would ignore the value of the building.

In actuality, however, only a small part of the assignee's premium payments can properly be characterized as expenditures for improvements or additions to the transferred policy. The other part of the payments are more in the nature of maintenance expenses.

To develop this point, we return to the economic components of a life insurance policy. An insurance policy has three components: the equity or terminal reserve component, the term insurance coverage component, and the right of continuation component.¹⁰³ To determine the death-time value of the gift accurately when the assignee pays the post-assignment premiums, the Tax Court should have identified and examined these components separately, since they are what the decedent's assignment transferred.

The equity reserve component. If the policy had an equity reserve component at the time of the transfer, the decedent clearly transferred it. The equity reserve may increase between the time of the transfer and the time of death. The increase is partly attributable to the appreciation of the equity reserve that the decedent transferred. That portion of the proceeds attributable to the transferred equity reserve component and the appreciation thereon is clearly includible in the transferor's gross estate.

A portion of the post-assignment premiums paid by the assignee is added to the equity reserve component. That portion, including the appreciation thereon, is in the nature of an improvement or addition to the property by the assignee, and should be excluded under section 2035.¹⁰⁴

103. See *supra* text accompanying notes 15-16.

104. It is arguable that when Congress amended § 2035 in 1981, it should have excluded the entire equity reserve component of a life insurance policy transferred within three years of death. The 1981 amendments restricted § 2035 to items of property in which the value of the gift is likely to be much less than the amount that would have been included in the transferor's gross estate if the transfer had not taken place. With respect to a transferred life insurance policy, the component that dramatically increases in value is the term insurance coverage component, not the equity reserve component. Because the equity reserve component does not dramatically increase in value at the insured's death, it is more like the types of property to which § 2035 no longer applies—property such as land or stocks and bonds. It would better suit tax policy then for Congress to have expressly excluded all of the equity reserve element of a life insurance policy from the insured's gross estate—i.e., the equity

That portion of the equity reserve was not transferred by the decedent and, since the insured did not pay those premiums, would not have been included in the insured's gross estate had the transfer not occurred.

*The term insurance coverage and the right of continuation components.*¹⁰⁵ An assignment of a life insurance policy also constitutes a gift of the term insurance coverage component. The value of the term insurance component at the time of death is the full value of the proceeds of the policy, less any equity reserve. In one respect, however, it could be argued that the term insurance coverage component *that the insured transferred* has expired by the time of death and was replaced by the term insurance coverage bought by the assignee's last premium payment. The question is, should the assignee's last premium payment be treated as a de novo purchase of term insurance coverage or should all of the assignee's premium payments combined be treated merely as a maintenance expense of the term insurance coverage that the insured transferred? The only reason that the assignee had the right to maintain the insurance coverage in force is

reserve at the time of the gift, the incremental additions thereto, the equity reserve added by the assignee's premium payments, and the incremental additions thereto.

As drafted, however, § 2035 clearly includes the equity reserve component in the transferor's gross estate. Perhaps Congress considered the several components of life insurance to be so blended into the proceeds payable at death as to make it inappropriate or administratively inconvenient to separate the proceeds into its several component elements. In fact, however, the amount of the equity reserve can be determined easily and presents no administrative or other difficulties.

More likely, Congress simply did not think about the idea of separating the elements that make up the proceeds payable at death. It would be worthwhile for Congress to consider amending § 2035 to exclude that portion of insurance proceeds attributable to the equity reserve component.

105. *At the time of assignment*, the value of these components is at least equal to the portion of the premium previously paid by the insured that is attributable to the remainder of the period for which that premium was paid. Thus, if the insured paid a premium of \$1,200 on March 1 for term insurance coverage for one year, and the insured assigned the policy to his wife three months later (on June 1), he would have made a gift having a value of at least \$900 (three-fourths of \$1,200). If the insured is in good health, this allocation of the premium will accurately reflect the value of both components. The amount of each premium will equal the value of the risk coverage involved; the premium will have been set according to an actuarial determination of the risk assumed by the insurer, including the granting to the policyholder of an option to continue that insurance coverage in future years at a cost designed for healthy persons. Stating it differently, if the assignee has an insurable interest in the insured, the assignee could purchase the same amount of insurance coverage, including a right of continuation component, at the same price. However, if the insured is in poor health at the time of the assignment, the premium payable for the term insurance coverage will be less than the actual value of such insurance coverage; consequently, the value of the insurance granted to the assignee (both the coverage for the remainder of the period and the option to continue the coverage at a bargain price) will exceed the premium allocation described above.

because the assignment of the policy carried with it the right of continuation component.¹⁰⁶

Rather than treating each premium payment as the purchase of an independent asset (risk coverage for a stated term), it is more accurate to characterize such payments as a maintenance expense of the term insurance coverage component. The insurance coverage element of a policy should therefore be treated as a continuum and not as a collection of a number of individual contractual arrangements—one for each term of a premium payment.¹⁰⁷

Treating insurance coverage as a continuum or single asset is not only a realistic view of the asset itself, it is necessary in order to accommodate the legislative purpose of section 2035 and to avoid great administrative burdens. If the assignee's last premium payment were treated as an independent purchase of risk coverage for the stated term, it might then be necessary to exclude the entire risk coverage element of the proceeds (that is, the difference between the amount of the proceeds and the reserve), since that value would then be deemed to have been added by the assignee.

Excluding this amount would frustrate the purpose of section 2035, which is to prevent the use of lifetime transfers in anticipation of imminent death as a means of minimizing transfer tax costs. Particularly when the insured was in poor health when assigning the policy, this method would overstate the amount added to the policy's value by the assignee. There is a way of preventing that frustration and overstatement, but doing so would necessitate valuing the risk coverage element of the policy at the time of

106. If the assignee had an insurable interest in the insured, the assignee could have bought a new policy on the insured, but not the existing policy that the insured transferred. If the insured was in poor health at the time of the assignment, the cost of a new policy would be much higher than the premiums on the existing policy. In fact, the insured's health might be so poor that he or she was then uninsurable.

107. In two earlier and now obsolete revenue rulings, the Service recognized that life insurance coverage is properly characterized as a continuum. Under pre-1982 law, when an insured assigned a straight life or a term policy more than three years before death but paid premiums within three years of death, the Service only included the amount of premiums paid by the insured within three years of death. See Rev. Rul. 71-497, 1971-2 C.B. 329; text accompanying *supra* note 56. This position treats a premium paid on term or straight life insurance as merely maintaining continuous insurance coverage, not as a *de novo* purchase of new insurance coverage. See also Rev. Rul. 82-13, 1982-1 C.B. 132, where the Service ruled that § 2035 did not apply to a case in which the insured, more than 3 years before death, assigned a group term, employer-paid policy to another. Although the insurance was for a term, it was subject to an automatic right of renewal by payment of the premiums for the next term. After the assignment, the employer continued to pay the premiums, which were therefore deemed to have been paid by the insured. Some of the premiums were paid within 3 years of the insured's death. Since the policy was renewable, the Service treated the premium payments as a continuation of a single policy, not as a *de novo* purchase of a new policy.

assignment and then deducting that value from the risk coverage element at death to determine the amount of the proceeds that actually are attributable to the assignee's premium payment. This method would provide a more accurate reflection of the assignee's addition to the value of the policy.

Valuing the risk coverage element at the time of assignment is objectionable, however, because it would require making an appraisal of the health of the insured at the time of assignment and making an actuarial and medical evaluation of the insured's life expectancy at that time. The difficulties in making that determination and the burden of exploring those issues led the government to value unmatured insurance policies for gift tax purposes without regard to the actual health of the insured.¹⁰⁸ The same difficulties point to rejecting the idea of valuing the risk coverage element of the policy at the time of assignment and then deducting that value from the risk coverage element at death to determine the amount of the proceeds that actually are attributable to the assignee's premium payment. Indeed, the factual problems raised by requiring such a valuation are reminiscent of the problems that arose in determining whether a transfer was made in contemplation of death. Congress replaced the "contemplation of death" test in 1976 with an automatic rule of inclusion just so that it could eliminate both the administrative burden of making inquiries of this type and the frequent factual errors made in resolving such issues. While it is true that the contemplation of death rule involved questions of subjective intent that would not be raised in examining the insured's state of health, it would still be necessary to look into the past and determine some aspect of an individual's personal state possibly without having any access to information from the individual.

Even if the health evaluation method were correct in theory, it would operate equitably only when the past health of the insured could be accurately determined. The great likelihood that substantial errors would be made in resolving such factual issues renders this approach undesirable. While treating the assignee's payments as maintenance of the right of continuation component is somewhat draconic, it has the advantage of being doctrinally supportable, not only for the reasons discussed above, but also because such treatment is consistent with the usual perceptions of the insured and assignee.

As previously noted, the portion of the assignee's premium payments that are added to the equity reserve should be deducted from the amount of death proceeds that otherwise would be included in the insured's gross estate. Viewing the assignee's contribution as a maintenance cost, the question is whether the proceeds should also be reduced by the rest of the assignee's post-assignment premium payments. Since the insured's gross estate would

108. See Rev. Rul. 77-181, 1977-1 C.B. 272; *supra* text accompanying notes 27-28.

have been reduced by such payments if the insured had retained the policy and made the premium payments (that is, the cash used to pay the insurance cost would no longer be part of the insured's assets), the assignee's payment should be treated as a contribution to the extent that the payment is allocated to the cost of purchasing insurance coverage (which cost includes the insurer's expenses that are passed on to its policyholders). Therefore, the amount of the portion of each premium payment that is not applied to the policy's reserve should also be deducted from the proceeds that are includible in the insured's gross estate.¹⁰⁹

Consequently, the proper method of calculating the amount includible under the old death-time-value-of-the-gift method was to include the full value of the proceeds less the *dollar amount* of the post-assignment premiums paid by the assignee, not by using the ratio of premiums paid by the insured to the total premiums paid on the policy, as the Tax Court did in *Silverman*. The Second Circuit, it turns out, had it right.¹¹⁰

The new what-would-have-been-included standard makes it unnecessary to identify and separately revalue the components of the policy that the insured transferred. The starting point is that a gift by the insured within three years of death of any incident of ownership requires inclusion of the full value of the proceeds. The question under this standard is whether there should be *any* reduction in the amount includible because of the assignee's premium payments, and if so how that reduction should be calculated.

We believe that that amount *should* be reduced by the dollar amount of the post-assignment premiums paid by the assignee. As noted above, if the insured had in fact retained the policy, the insured would have paid the premiums in order to maintain the policy. Because those premium payments would have reduced the amount includible in the insured's gross estate under section 2033, the assignee's premium payments should be deducted from the full value of the proceeds in order to determine the amount ultimately includible under section 2035 in its current form. We make this argument purely as a matter of tax policy. Section 2035 makes no provision for such a reduction. It requires inclusion of the amount that would have been

109. Cf. *Estate of Peters v. Commissioner*, 386 F.2d 404 (4th Cir. 1967) (the value of a surviving joint tenant's capital improvements were deducted from the value of jointly owned property that was included in the decedent's gross estate under § 2040). The joint tenants were the decedent and her son.

110. Recall that the Second Circuit expressed uneasiness about the Tax Court's use of the ratio of premium payments to calculate the amount includible, and noted that another possible approach would be to include the full dollar value of the proceeds, reduced only by the dollar amount of the post-assignment premiums paid by the son. See *supra* text accompanying note 95.

included *under section 2042* had the gift not been made, not the amount that would have been included overall. Our position is that it is consistent with tax policy to graft this reduction onto section 2035, either by administrative or judicial construction.

The final question is, what if the insured, not the assignee, paid the post-assignment premiums? Under the case law and rulings that predated the 1997 Act, the full value of the proceeds was included without any reduction for the amount of the post-assignment premiums.¹¹¹ One could argue that in substance the insured's post-assignment premium payments should be attributed to the assignee.¹¹² The rationale would be that the assignee, as owner of the policy, is the only one entitled to pay the premiums on the policy.¹¹³ Consequently, if without objection from the assignee the insured pays the post-assignment premiums directly, the transaction could be treated as a gift from the insured to the assignee of the cash amount of the premiums, coupled with a constructive payment of the premiums by the assignee.¹¹⁴

Assuming that post-assignment premiums paid by the insured are properly treated as constructively made by the assignee, the question still remains whether the amount of the constructive payments should reduce the amount of the proceeds that are included in the insured's gross estate under the what-would-have-been-included standard of the 1997 Act. Our argument for such a reduction when the assignee actually pays the post-assignment premiums rests on the theory that the insured would have paid the premiums if the policy had not been assigned, thus removing the amount of those payments from the insured's gross estate. It is another matter, however, to grant such a reduction when the assignee pays the premiums from funds obtained from the insured.

Whether there should be such a reduction turns on the extent to which the assignee's payments constitute an act that is independent from the insured's gifts to the assignee. When the insured pays the premiums directly, the gifts to the assignee are in effect conditioned on being used to pay the premiums, making the gifts so connected to the premium payments that the rationale for reducing the includible insurance proceeds by the amount of the

111. See cases and rulings cited *supra* note 7.

112. See Lauer, *supra* note 81, at 725-27.

113. See *id.* at 686, 726.

114. In other contexts, the tax law has so treated the payment of another's debt. See, e.g., Rev. Rul. 57-481, 1957-2 C.B. 48, in which the Service ruled that a third party's payment (as a gift or loan to the taxpayer) of interest owed by the taxpayer on a loan is a payment by the taxpayer, making it deductible by the taxpayer under the provisions then existing that allowed an income tax deduction for interest payments. This line of authority is analogous to the insured's payment of premiums on a policy owned by the assignee, despite the fact that the assignee has no legal obligation to pay those premiums.

assignee's premium payments is negated. In that case, the payments do not reflect amounts that substitute for what otherwise would have been payments that reduce the insured's gross estate. Since the premium payments were derived from the insured, the gifts already reduced the insured's gross estate. No additional reduction by deducting the payments from the insurance proceeds is justified.

VIII. CONCLUSION

We end where we began. The Taxpayer Relief Act of 1997 furnishes the courts and the Internal Revenue Service an opportunity to rectify the erroneous conclusion reached by the Tax court in *Silverman*, which affords taxpayers unwarranted opportunities for tax avoidance.

The *Silverman* analysis gives taxpayers a windfall and provides life insurance an unfair advantage over other investment vehicles. *Silverman* misapplied the death-time-value-of-the-gift standard and, more importantly, is inconsistent with the what-would-have-been-included standard expressly adopted by section 2035 as reformulated by the 1997 Act. If the insured dies within three years after making the gift, the full value of the proceeds less the dollar amount of the premiums paid by the assignee should be included under section 2035 as reformulated by the Taxpayer Relief Act of 1997.